DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 06-0033
Income Tax
For The Tax Period 1993-2002

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Issues

I. Tax Administration – Service

Authority: IC § 6-8.1-5-1(a); *Thomas v. Indiana Dep't of State Revenue*, 675 N.E.2d 362 (Ind. Tax 1997).

The Taxpayer contends that inadequate notice of tax liabilities denied the Taxpayer's due process rights to a hearing.

II. Adjusted Gross Income Tax, Gross Income Tax, and Supplemental Net Income Tax – Nexus

Authority: IC § 6-8.1-5-1(b); IC § 6-3-2-1; IC § 6-2.1-2-2(a)(2); IC § 6-3-8-1; *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) and *National Bellas Hess Inc. v. Department of Revenue, State of Ill.*, 386 U.S. 753 (1967); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C.1993), *cert. denied*, 510 U.S. 992 (1993).

The Taxpayer contends that it had inadequate nexus to be subject to Indiana corporate income taxes.

III. Adjusted Gross Income Tax – Apportionment

Authority: IC § 6-3-2-2(l); 45 IAC 3.1-1-55(e).

The Taxpayer protests the computation of the adjusted gross income tax due.

IV. Tax Administration- Ten Percent Negligence Penalty

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2(b).

The Taxpayer protests the imposition of the ten percent negligence penalty.

Statement of Facts

The Taxpayer is a Delaware corporation. It has a subsidiary corporation in Illinois. That subsidiary corporation owned a manufacturing plant in Indiana during the tax period. The Taxpayer owns a portfolio of investment assets including intellectual properties. The subsidiary corporation paid the Taxpayer royalty fees associated with the use of patents, trademarks, tradenames, copyrights, and trade secrets used by the Indiana manufacturing facility. Pursuant to an audit, the Indiana Department of Revenue (Department) assessed additional gross income tax, adjusted gross income tax, supplemental net income tax, interest, and penalty on the Taxpayer's receipt of those royalty fees for the years 1993-2002. The taxpayer protested. A hearing and additional meeting were held. This Letter of Findings results.

I. Tax Administration – Service

Discussion

The Taxpayer's first protest concerns procedural issues. The Department issued "Notices of Proposed Assessment" to the Taxpayer pursuant to the provisions of IC § 6-8.1-5-1(a). The Taxpayer contended that it did not receive either the original or subsequent notices or requests for payment issued by the Department. The Taxpayer argued that since it did not receive the notices, it was unable to request a hearing before the Department within the statutory time frame. The Taxpayer argues that its due process rights were violated when it did not receive adequate notice to timely request a hearing on the issue.

The Indiana Tax Court case *Thomas v. Indiana Dept of State Revenue,* 675 N.E.2d 362 (Ind. Tax 1997) dealt with a similar procedural problem. In that case the Department issued tax warrants against James W. Thomas even though Mr. Thomas had submitted a letter protesting the assessment and requesting a hearing. Later, the Department recalled the tax warrants and granted Mr. Thomas a hearing. The Tax Court found there had only been harmless error because the Department remedied the situation by granting Mr. Thomas his hearing. In this case, also, any error was harmless because the Department granted the Taxpayer a hearing on its protests to the assessments.

Finding

The Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax, Gross Income Tax, and Supplemental Net Income Tax – Nexus

Discussion

All tax assessments are presumed to be valid. IC § 6-8.1-5-1(b). The Taxpayer bears the burden of proving that any assessment is incorrect. Id.

The Department imposed adjusted gross income tax pursuant to IC § 6-3-2-1. The Department imposed gross income tax pursuant to IC § 6-2.1-2-2(a)(2). The Department imposed supplemental net income tax pursuant to IC § 6-3-8-1. The Taxpayer protested the imposition of these taxes.

The Taxpayer argued that Indiana violated the Commerce Clause of the United States Constitution by imposing the subject income taxes. The Taxpayer based this argument on *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992) and *National Bellas Hess Inc. v. Dep't. Of Revenue,* 386 U.S. 753 (1967). These cases disallowed the imposition of sales and use taxes in states where the Taxpayers did not have a physical presence in the taxing states. The Taxpayer argued that since it also did not have any offices, employees, or property in Indiana, the Taxpayer did not have the physical presence or substantial nexus necessary to subject it to Indiana income taxation.

The Taxpayer's assessment is for income taxes, not sales and use taxes as in the cited cases. The United States Supreme Court declined to review the imposition of state corporate income taxes on royalty income from trademarks and a tradename in *Geoffrey, Inc. v. South Carolina Tax Comm'n,* 437 S.E.2d 13 (S.C.1993), *cert. denied*, 510 U.S. 992 (1993). While *Geoffrey* is not binding on the Department, the reasoning is sound and supports the imposition of corporate income taxes on the Taxpayer's Indiana royalty income under Indiana law.

Geoffrey, Inc. was an out-of-state wholly owned subsidiary of Toys R Us, Inc. Geoffrey, Inc. did not have offices, property, or employees located within South Carolina. Geoffrey, Inc. owned trademarks, tradenames, and marketing "know-how" that its parent corporation (Toys R Us, Inc) used in South Carolina. South Carolina imposed corporate income taxes on the royalty income Geoffrey, Inc. received from the Toys R Us, Inc. stores in South Carolina. The court differentiated the sales and use taxes from corporate taxes and held that the physical presence necessary to establish a substantial nexus for the purposes of imposing sales taxes was not required for the imposition of corporate income taxes. Rather, the court held that deriving income from the use of intangibles in a state established a substantial nexus and satisfied the requirements of the Commerce Clause.

The Taxpayer attempted to distinguish its situation from *Geoffrey* by citing the differences in corporate structure between them. How Geoffrey, Inc. and the Taxpayer organized their group of related corporations is not germane in considering the imposition of the corporate income taxes on royalty income. The elements establishing proper imposition of corporate income taxes are identical in both instances. Both Geoffrey, Inc. and the Taxpayer are out-of-state corporations with no employees, property, or offices in the taxing state. Both Geoffrey, Inc. and the Taxpayer receive royalty payments based on the use of intellectual property in the state imposing tax. Both Geoffrey, Inc. and the Taxpayer have sufficient nexus with the taxing state for the purposes of imposing corporate income taxes on the income from royalty payments for use of the intellectual property in the taxing state. Since there are no material distinctions concerning the imposition of the corporate income taxes on royalty income between Geoffrey, Inc. and the Taxpayer, the *Geoffrey* case provides no support for the Taxpayer. The Department properly imposed corporate income taxes on the Taxpayer pursuant to Indiana statutes.

Finding

The Taxpayer's protest is respectfully denied.

III. Adjusted Gross Income Tax – Apportionment

Discussion

The Department assessed adjusted gross income tax on the royalties the Taxpayer received from the Indiana manufacturing plant. The Taxpayer protested this assessment.

The Taxpayer argued that the tax should have been determined pursuant to the provisions of 45 IAC 3.1-1-55(e) as follows:

> Gross receipts from intangible personal property shall, if classified as business income, be attributed to this state based upon the ratio which the total property and payroll factors in this state bears to the total of the property and payroll factors everywhere for the tax period as determined in Regulations 6-3-2-2(c)(010) [45 IAC 3.1-1-40] et seq. and 6-3-2-2(d)(010) [45 IAC 3.1-1-1-47] et seq.

The Taxpayer argues that since it has no property or payroll in Indiana, both the property and payroll factors are zero. Therefore, no adjusted gross income tax on the receipts from royalty income for intellectual property used at the Indiana manufacturing facility would be due.

The Taxpayer errs in this conclusion.

The calculation of the Taxpayer's Indiana source royalty income is governed by IC § 6-3-2-2(l) that states as follows:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all of any part of the taxpayer's business activity, if reasonable:
> (1) separate accounting:
> (2) the exclusion of any one (1) or more of the factors;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The tax returns of the Indiana manufacturing facility's parent company indicate that royalty payments were made to the Taxpayer for the manufacturing facility's use of intellectual property in the years 1993, 1994, 1998, 1999, and 2000. It has already been determined that adjusted gross income tax is due on these receipts. The use of the regular apportionment factors as set out in 45 IAC 3.1-1-55(e) result in a zero tax

liability. Clearly, that does not fairly represent the Taxpayer's Indiana source income. Therefore, the Department is required to use another method to equitably apportion the Taxpayer's Indiana source income.

The audit determined the Taxpayer's corporate income tax liability by using information from the income tax returns of the Illinois parent corporation for the years those returns were available. The additional years were estimated based upon the available tax returns. The audit employs an appropriate method to determine the Taxpayer's taxable receipts from Indiana sources.

Finding

The Taxpayer's protest is respectfully denied.

IV. Tax Administration- Ten Percent Negligence Penalty

Discussion

The Taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of

findings, rulings, letters of advice, etc;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Taxpayer provided substantial documentation to indicate that its failure to pay the assessed adjusted gross income tax was due to reasonable cause rather than negligence.

Finding

The Taxpayer's protest is sustained.

KMA/JR/WL/DK – March 19, 2007